

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JOHN MANNING & COMPANY, INC.) No, **84A-482-VN**

Appearances:

For Appellant: Thomas W. Petrovich
Certified Public Accountant

For Respondent: Paul J. **Petrozzi**
Counsel

O P I N I O N

This appeal is made pursuant to section **25666^{1/}** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of John Manning & Company, Inc., against a proposed assessment of additional franchise tax in the amount of \$5,309 for the income year ended February 29, 1980.

I/ Unless otherwise specified, all section references **are** to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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The issue presented by this appeal is whether appellant has shown that respondent's disallowance of a claimed addition to its bad debt **reserve** constituted an abuse of discretion.

Appellant is a California corporation engaged in the business of packing, shipping, and selling produce, especially tomatoes and strawberries. In the normal course of its business operations, appellant bargains with a grower to cultivate a crop and assumes all or part of the cost of production by advancing loans to the grower. The loans are secured by liens on the crop. Appellant frequently shares the financial burden for the advances with a particular produce broker. After the grower harvests a contracted crop, appellant then packs, ships, and sells the produce to various buyers. From the sales proceeds, appellant realizes a commission and recoups the amounts of the advances as well as its packing expenses. The remaining balance of the sales proceeds is then paid to the grower.

As an accrual-basis taxpayer, appellant has elected the reserve method of accounting for its bad debts. On its franchise tax return for the income year ended February 29, 1980, appellant claimed a deduction of **\$58,791.04** for an addition to its bad debt reserve. Respondent determined that appellant's existing reserve was adequate to cover those losses reasonably expected to result from its accounts receivable. Respondent thereupon disallowed the claimed deduction for the addition and issued the proposed assessment of additional tax reflecting the disallowance. Appellant protested this action, but respondent affirmed the proposed assessment. This appeal followed.

Section 24348 allows a deduction for a **reasonable** addition to a reserve for bad debts in lieu of a deduction of a specific debt that becomes worthless within the income year. This section provides that, if a taxpayer elects to employ the reserve method of accounting for its bad debts instead of the specific charge-off method, any addition claimed will be subject to the discretion of **the** Franchise Tax Board. Internal Revenue Code section 166, the federal counterpart to section 24348, vests the same discretion in the Commissioner of Internal Revenue to determine the reasonableness of a federal taxpayer's addition to its reserve for bad debts. Because of the substantial similarity between the two sections, federal precedent is persuasive of the proper

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interpretation of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

In general, a reserve for bad debts represents merely an estimate of future losses which can reasonably be expected to be sustained from obligations outstanding at the close of the **income** year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980); Handelman v. Commissioner, 36 T.C. 560 (1961).) Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the income year and is increased by credits it with reasonable additions which are deductible. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963).) What constitutes a reasonable addition is a factual matter depending upon conditions of business prosperity, the total amount of debts outstanding at the end of the **year**, including current debts as well as those of prior years, and the total amount of the **existing reserve**. (Treas. Reg. **§ 1.166-4(b)(1)**; Mills & Lupton Supply Company, Inc. v. Commissioner, ¶ 77,294 T.C.M. (P-H) (1977).) A basic requirement for an addition to a bad debt reserve is that the addition must reflect conditions existing at the end of the income year in question. (Roanoke Vending Exchange, Inc. v. Commissioner, supra; Treas. Reg. **§ 1.166-4(b)(1)**.)

-The ultimate question in determining the reasonableness of an addition is whether the total balance in the reserve at year's end is adequate to cover the expected future losses from existing bad debts, **not** whether the proposed addition is sufficient for that purpose. (Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942); Massachusetts Business Development Corp. v. Commissioner, 52 T.C. 946 (1969).) If the existing reserve is adequate to cover reasonably anticipated losses, any further additions to the reserve will be considered unreasonable and not deductible. (Valmont Industries, Inc. v. Commissioner, supra; Messer Co. v. Commissioner, 57 T.C. 848 (1972).) On the other hand, if at the **close** of the taxable year the reserve appears inadequate to absorb the portion of a taxpayer's accounts receivable which reasonably can be expected to prove worthless, the amount in the reserve should be increased by an appropriate addition which the taxpayer is entitled to deduct. (Westchester Development Co. v. Commissioner, 63 T.C. 198 (1974); R. Gsell & Co. v. Commissioner, 34 T.C. 41 (1960).) In that case, "[a] 'reasonable' addition is the amount necessary to bring the reserve balance up to the level that can be expected

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to cover losses properly anticipated on debts outstanding at the **end of** the tax year." (Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 546 [58 L.Ed.2d 785] (1979).)

Should a taxpayer challenge the disallowance by the Franchise Tax Board of a claimed **addition** to a bad debt reserve, the taxpayer bears a particularly heavy burden of proof due to the discretion granted to respondent by statute. (James A. Messer Co. v. Commissioner, supra; Willard v. Commissioner, ¶ 83,656 T.C.M. (P-H) (1983); Ehlen v. United States, 323 F.2d 535 (Ct.Cl. 1963); Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.) The taxpayer is required not only to demonstrate that its claimed addition is reasonable, but it must also establish that respondent's action in disallowing the claimed addition was arbitrary and amounted to an abuse of discretion. (Thor Power Tool Co. v. Commissioner, supra, 439 U.S. at 547-548; Roanoke Vending Exchange, Inc. v. Commissioner, supra; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.)

In the present appeal, respondent employed the six-year moving average formula derived from the decision in Black Motor Co. v. Commissioner, supra, in its **determination** to disallow appellant's claimed addition to its bad debt reserve. The use of this formula to calculate reasonable additions to a reserve was upheld by the United States Supreme Court in the decision in Thor Power Tool Co. v. Commissioner, supra. The Black Motor formula utilizes the loss experience of the taxpayer in the previous six years **and** establishes a percentage level for the reserve in determining the need and amount of an addition for a current income year. Here, respondent used the formula to calculate the appropriate amount for appellant's total bad debt reserve and determined that its claimed addition was not justified by its recent bad debt history.

While it will generally use the Black Motor formula to determine a reasonable addition, the Internal Revenue Service concedes that it is not the exclusive means for determining the reasonableness of an addition. (Rev. Rul. 76-362, 1976-2 C.B. 45.) The United States Tax Court initially recognized that a formula which produces a reasonable addition in one year may lead to an arbitrary result in another year due to the circumstances involved. (Black Motor Co. v. Commissioner, supra, 41 B.T.A. at 304; R. Gsell & Co. v. Commissioner, supra, 34

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T.C. at 56; Gurentz v. Commissioner, ¶ 78,238 T.C.M. (P-H) (1978).) In the event that a taxpayer's most recent bad debt experience is unrepresentative for any reason or if changes in business conditions indicate that such past experience **is** not a reliable guide in forecasting future losses, a **formula** using that experience cannot be expected to produce a reasonable addition. (Thor Power Tool Co. v. Commissioner, supra, 439 U.S. at 549; Willard v. Commissioner, supra.) Thus, the United States Supreme Court has held that if the taxpayer can point to conditions that will cause future debt collections to be less likely than in the past, the taxpayer is entitled to an addition larger than the Black Motor formula would call for. (Thor Power Tool Co. v. Commissioner, supra, 439 U.S. at 549; see also Rev. **Rul.** 76-362, supra.)

In this case, appellant contends that its claimed addition was reasonable in view of the known circumstances surrounding the crop of a major debtor. In July 1979, appellant entered into an agreement with Montalvo Berry Farms, Ltd., (MBF) for a strawberry crop. During the next few months, appellant provided the customary advances to MBF to cultivate the crop but noticed that the requests for advances were higher than those for the previous year. By December 1979, appellant had advanced \$350,000 which was more than it had originally planned to lend to MBF and more than the expected cost for growing a strawberry crop. MBF, however, required even more money to continue production. Upon inspection of the MBF strawberry fields, appellant discovered that the condition of the prospective crop was poor and estimated that the yield from the crop would not cover the cost of its advances. Since MBF had not obtained from another source the additional financing necessary to complete the cultivation of the crop, appellant decided at that time that it would not provide any more advances.

Subsequently, MBF secured a commitment for a loan from a third party, Pick-d Rite, Inc. (PR). PR agreed to advance \$300,000 to MBF on the condition, however, that its crop lien have priority over appellant's existing lien after June 1, 1980. In other words, PR demanded that the proceeds from the harvested strawberry crop go to satisfy its loan first after that date. Rather than seeing MBF abandon the crop, appellant agreed to subordinate its lien in order to recoup as much of its own advances as possible. PR then provided MBF with \$48,000 on December 7, 1979, and another \$227,000 on January 6, 1980.

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By February 28, 1980, MBF owed appellant the sum of **\$372,482.55** which constituted 84 percent of the value of appellant's accounts receivable. In addition, MBF owed another \$275,000 to PR. At the end of the income year in question, **appellant** thus argues, it knew that collection of the full amount of its MBF debt was unlikely due to the poor crop conditions and the high debt liability of the grower; Based on these facts, appellant estimated that the total loss from **the MBF** transaction would be at least \$100,000, half of which it would assume under its financial arrangements. Since its reserve stood at \$5,184, appellant therefore claims that the addition to its bad debt reserve of **\$58,791.04** was a reasonable sum,

The Franchise Tax Board attacks the alleged reasonableness of the claimed addition on essentially three grounds. First, respondent takes the position that appellant's past loss experience does not justify an addition of **\$58,791.04** for the year under appeal. Respondent notes that appellant incurred a \$2,500 loss in the preceding-year and a total loss of approximately \$9,000 during the past **six years**. Respondent admits that farming is a high risk venture but surmises that the absence of any substantial losses in its recent debt history is due to appellant's skill in managing its accounts receivable.

In the present case, it appears that appellant employed that very skill and foresight to estimate a reasonable addition to its bad debt reserve. The Thor Power Tool Co. case makes clear that if a taxpayer-cite changes **in** business conditions **or specific** customers that make debt collection less likely than in **prior** years, then its loss experience should be disregarded in **esti-** mating a reasonable addition to its bad debt reserve. Here, appellant has demonstrated that the financial difficulties of a major debtor-grower made collection of its advances less likely than in prior years. Appellant realized in late 1979 that the yield from the MBF crop would be lower due to the poor condition of the strawberry plants. Not only was the amount of its advances higher than the preceding income year, but also appellant was aware that MBF had to borrow cash from another broker to produce the strawberry crop. When estimating its losses at the end of the income year, appellant was thus faced with a situation where its loans were supposed to be repaid from a poor crop and the yield therefrom would not inure to its full benefit due to the subordination of its lien. Based on the record before us, **we find** that

• appellant has shown its claimed addition to be reasonably

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based on known conditions existing at the end of the income year in question.

Second, respondent argues that appellant's subsequent action belies its belief that the MBF debt would not be repaid in the estimated amount. In support of this contention, respondent notes that appellant provided further advances after the income year. Respondent claims that this constitutes evidence that appellant believed its loans would be repaid. Appellant explains, however, that these advances were applied solely towards the cost of **harvesting or** picking the strawberry crop. Unlike the prior production advances, appellant states that it had control over the recovery of these picking advances. Since it marketed the picked fruit and received the sales proceeds from buyers, appellant was entitled to reimburse itself for the picking advances even before its production advances were repaid. Appellant also argues that the monies were furnished with the purpose of mitigating its losses from the production advances and does not reflect a belief that its loans were recoverable in **full**. In light of the guarantee for repayment and the amount of its existing investment in the strawberry crop, we find appellant's explanation for its subsequent advances to be reasonable and not inconsistent with the **claim** for the addition to its bad debt reserve. We further observe that appellant had earlier demonstrated that it anticipated losses from the MBF account when it refused to advance more monies for production after **making the** field inspection. (See Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457 (1969).)

Third, respondent argues that appellant could not have anticipated that MBF would become insolvent later in 1980 and fail to repay **\$167,012.63** of its debt. In general, while a taxpayer cannot rely solely on subsequent events to support the reasonableness of its claimed addition, the actual loss experience of the taxpayer after the income year in question may be used as additional evidence to confirm the reasonableness of its method of computing the claimed addition to the reserve. (Westchester Development Co. v. Commissioner, supra; Roanoke Vending Exchange, Inc. v. Commissioner, supra.) Here, respondent is the party who has offered appellant's subsequent loss history to repudiate the claimed addition. Appellant itself has not claimed that it knew that MBF would file for bankruptcy or go out of business. The basis for its claimed addition was the condition of the strawberry crop and the total nature of **MBF's** loan obligations at the end of the income year. Nevertheless,

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appellant's loss experience after the harvest of the crop bears out the reasonableness of its claimed addition. Its allocated portion of the actual loss from the MBF transaction was approximately \$90,000, which turned out to be even higher than the amount of the claimed addition.-

In conclusion, we find that respondent's failure to take into account appellant's changed business circumstances constituted an abuse of discretion. (Valmont Industries, Inc. v. Commissioner, supra; Richardson v. United States, 330 **F.Supp.** 102 (S.D. Tex. 1971),). More-over, respondent's failure to consider the **adverse** circumstances affecting the specific MBF debt in determining the reasonableness of appellant's claimed addition was arbitrary. (Calavo, Inc. v. Commissioner, 304 **F.2d** 650 (9th Cir. 1962); Appeal of Pringle Tractor Co., Cal. St. Bd. of Equal., **Mar. 7**, 1967; Appeal of Commonwealth Financial Corporation, Cal. St. Bd. of Equal., Apr. 19, 1985.) Based on the foregoing, respondent's action in this matter must be reversed.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of John Manning & Company, Inc., against a proposed assessment of additional franchise tax in the amount of \$5,309 for the income year ended February 29, 1980, be and the same is hereby reversed.

Done at Sacramento, California, this 3rd day of December , 1985, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Nevins and Mr. Harvey present.

_____	Chairman
Conway H. Collis	, Member
Richard Nevins	, Member
Walter Harvey*	, Member
_____	Member

*For Kenneth Cory, per Government Code section 7.9